# NOTE 8 – DEPOSITS AND INVESTMENTS

## A. General Information

This note provides information for all deposits and investments except those of the Common Cash pool, which are described in Note 5. GASB Statement No. 3 requires certain disclosures regarding policies and practices with respect to deposits, investments, and the custodial credit risk associated with them.

### Deposits

In accordance with GASB Statement No. 3, deposits are classified into three categories of custodial credit risk as follows:

***Category 1:*** Insured or collateralized with securities held by the entity or by its agent in the entity's name.

***Category 2:*** Collateralized with securities held by the pledging financial institution's trust department or agent in the entity's name.

***Category 3:*** Uncollateralized (this includes any bank balance that is collateralized with securities held by the pledging financial institution, or by its trust department or agent, but not in the entity's name).

### Investments

In accordance with GASB Statement No. 3, investments are also classified into three categories of custodial credit risk as follows:

***Category 1:*** Insured or registered, or securities held by the entity or its agent in the entity's name.

***Category 2:*** Uninsured and unregistered, with securities held by the counterparty's trust department or agent in the entity's name.

***Category 3:*** Uninsured and unregistered, with securities held by the counterparty or by its trust department or agent but not in the entity's name. (This includes the portion of the carrying amount of any repurchase agreement that exceeds the fair value of the underlying securities.)

Certain types of investments are not categorized because they are not evidenced by securities that exist in physical or book entry form. Deposits classified as investments on the balance sheet are included in the investment tables following and are categorized using the deposit risk category definitions.

In accordance with GASB Statement No. 28, Accounting and Financial Reporting for Securities Lending Transactions, securities lent at year-end for cash collateral have not been categorized by custodial risk, while securities lent for securities collateral have been categorized.

## B. Deposits and Investments - Primary Government

### Deposits

In addition to equity in the Common Cash pool, some State funds maintain deposits with financial institutions. At year-end, the carrying amount of such deposits, excluding those classified as investments, was negative $11.1 million, which was caused primarily by a net book cash overdraft in an account maintained by the Michigan Unemployment Compensation Funds (MUCF). The deposits were reflected in the accounts of the banks at $12.6 million. Of the bank balances, $.2 million was covered by federal depository insurance or by collateral held by the State's agents in the State's name (GASB credit risk category #1), $11.3 million was covered by collateral held in the pledging banks' trust departments in the State's name (GASB credit risk category #2), and $1.2 million was uninsured and uncollateralized (GASB credit risk category #3).

### Investments

Investment authority for the State's pension (and other employee benefits) trust funds is found in P.A. 314 of 1965, as amended. This act allows the State Treasurer, as investment fiduciary, to make diverse investments in stocks, corporate and government bonds and notes, mortgages, real estate, venture capital, and other investments. The act has prudence standards and requires that the assets of a retirement system shall be invested solely in the interest of the participants and beneficiaries and be made for the exclusive purpose of providing benefits to the participants and the participants' beneficiaries, and of defraying reasonable expenses of investing the assets of the State system.

The State Treasurer is also authorized to invest a limited amount of pension (and other employee benefits) trust funds in futures contracts. At September 30, the pension (and other employee benefits) trust funds had a total of $205.0 million (market value) invested in such investments, which were made in Standard & Poors 500 and Standard & Poors Midcap Index futures contracts during the year. Derivatives are used for a small amount of the pension (and other employee benefits) trust fund portfolios to provide additional diversification. However, derivatives are not used for speculation and they are not used to leverage the investment portfolios. Less than 7% of the total pension (and other employee benefits) trust funds portfolio has been invested from time to time in futures contracts and swap agreements. The swap agreements provide that the retirement systems will pay quarterly, over the term of the swap agreements, interest indexed to the three month London Interbank Offered Rate (Libor), adjusted for an interest rate spread, on the notional amount stated in the agreements. United States domestic Libor-based floating rate notes were purchased in the open market to correspond with the notional amount of the swap agreements. The State Treasurer maintains custody and control of these notes. Swap agreements represent the largest category of derivatives used and total 6.4% of the total portfolio.

State statutes allow the pension (and other employee benefits) trust funds or other State funds to participate in securities lending transactions. The State Treasurer has authorized the agent bank to lend pension (and other employee benefits) trust fund or other State fund securities to broker-dealers and banks pursuant to a form of loan agreement.

The investment authority for other State funds is found in their enabling statutes and/or their bond resolutions where applicable. Except as noted below, the investments of the non-pension (and other employee benefits) trust funds are comprised mostly of United States government securities.

The State Building Authority makes diverse investments as allowed by State statute and/or bond resolutions.

Investments of MUCF represent their interest in a U.S. Treasury trust fund managed by the Secretary of the Treasury pursuant to Title IX of the Social Security Act, which includes deposits from the unemployment compensation funds of various states. MUCF is credited quarterly with trust fund investment earnings, as computed on a daily basis.

The deferred compensation plans are invested in mutual funds, U.S. Treasury strips, money market funds, and pooled investment funds. During fiscal year 2000-2001, the deferred compensation plans' investment activities were managed by a private investment firm, which invests as directed by members of the plan.

As a matter of administrative policy, the State Treasurer makes only limited use of investments in repurchase agreements. No such investments were outstanding at year-end.

The following table shows the carrying amounts and fair values of investments of the primary government by investment type and in total (in millions) at September 30:

| | GASB Category | | | | | |
|---|---|---|---|---|---|---|
| | #1 | #2 | #3 | Not Categorized | Total Carrying Value | Fair Value |
| Prime commercial paper | $ 3,082.4 | $ - | $ 40.5 | $ - | $ 3,122.9 | $ 3,117.5 |
| Short-term issues | 200.0 | - | - | 100.0 | 300.0 | 301.5 |
| Money market funds | - | - | - | 244.3 | 244.3 | 244.3 |
| Government securities | 4,348.2 | - | 165.8 | 104.0 | 4,618.1 | 4,618.1 |
| Investment agreements | 17.5 | - | - | - | 17.5 | 17.5 |
| Corporate bonds and notes | 4,524.6 | - | - | - | 4,524.6 | 4,524.6 |
| Equities | 18,470.8 | - | - | - | 18,470.8 | 18,470.8 |
| Mortgages | - | - | - | 44.6 | 44.6 | 44.6 |
| Real estate (1) | 93.1 | - | - | 4,148.1 | 4,241.2 | 4,241.2 |
| Venture capital and leveraged buyouts | 288.4 | - | - | 6,617.9 | 6,906.3 | 6,906.3 |
| International | 2,987.7 | - | - | - | 2,987.7 | 2,987.7 |
| U.S. Treasury (unemployment) trust fund | - | - | - | 2,834.5 | 2,834.5 | 2,834.5 |
| Mutual funds | - | - | - | 1,576.8 | 1,576.8 | 1,576.8 |
| Pooled investment funds | - | - | - | 1,714.0 | 1,714.0 | 1,714.0 |
| Security Lending Transactions: | | | | | | |
| Government securities | - | - | - | 1,629.1 | 1,629.1 | 1,629.1 |
| Corporate bonds and notes | - | - | - | 59.7 | 59.7 | 59.7 |
| Equities | - | - | - | 400.4 | 400.4 | 400.4 |
| Total Investments | $ 34,012.7 | $ - | $ 206.3 | $ 19,473.6 | $ 53,692.6 | $ 53,688.7 |

As Reported on the Statements of Net Assets and Statement of Fiduciary Net Assets

| | Current Investments | Non-Current Investments | Total |
|---|---|---|---|
| Governmental activities | $ 296.3 | $ 523.3 | $ 819.6 |
| Business-type activities | 2,943.3 | 709.3 | 3,652.7 |
| Fiduciary funds | 3,658.6 | 45,561.7 | 49,220.3 |
| | $ 6,898.3 | $ 46,794.4 | $ 53,692.6 |

(1) Category 1 real estate represents Real Estate Investment Trusts (REITs) which are evidenced by securities.

The cash collateral received on security lending transactions totaled $2.2 billion.

Pension (and other employee benefits) trust fund investments represent 91.3% of the total investments of the primary government. Other large holders of investments were the State Lottery Fund and MUCF.

The State Lottery Fund investments, $818.1 million, are all in the form of zero coupon U.S. Treasury bonds. As described more fully in Note 17, these investments are held to provide funding for deferred prize awards.

### Securities Lending Transactions

Under the authority of P.A. 314 of 1965, the State lends securities of the pension (and other employee benefits) trust funds and the State Lottery Fund to broker-dealers and other entities for collateral that will be returned for the same securities in the future. The custodian is not liable for any losses unless there is negligence or willful misconduct on its part. State statutes allow the Michigan Public School Employees, Michigan State Employees, Michigan State Police, and Michigan Judges Retirement Systems to participate in securities lending transactions, and the retirement systems have, via a Securities Lending Authorization Agreement, authorized the agent bank to lend its securities to broker-dealers and banks pursuant to a form of loan agreement. During the fiscal year, the agent bank lent, at the direction of the retirement systems, the retirement systems' securities and received: cash (United States and foreign currency), securities issued or guaranteed by the United States government, sovereign debt rated A or better, convertible bonds, and irrevocable bank letters of credit issued by a person other than the borrower or an affiliate of the borrower as collateral. The agent bank did not have the ability to pledge or sell collateral securities delivered absent a borrower default. Borrowers were required to deliver collateral for each loan equal to: 1) in the case of loaned securities denominated in United States dollars or whose primary trading market was located in the United States or sovereign debt issued by foreign governments, 102% of the market value of the loaned securities; and 2) in the case of loaned securities not denominated in United States dollars or whose primary trading market was not located in the United States, 105% of the market value of the loaned securities.

The retirement systems did not impose any restrictions during the fiscal year on the amount of the loans that the agent bank made on its behalf. There were no failures by any borrowers to return loaned securities or pay distributions thereon during the fiscal year. Moreover, there were no losses during the fiscal year resulting from a default of the borrowers or the agent bank.

During the fiscal year, the retirement systems and the borrowers maintained the right to terminate all securities lending transactions on demand. The cash collateral received on each loan was invested, together with the cash collateral of other qualified tax-exempt plan lenders, in a collective investment pool. As of September 30, 2001, the investment pool had an average duration of 75 days and an average weighted maturity of 551 days. Because the loans were terminable at will, their duration did not generally match the duration of the investments made with cash collateral. On September 30, 2001, the retirement systems had no credit risk exposure to borrowers. The collateral held and the market value of securities on loan for the retirement systems as of September 30, 2001, were $2.1 billion and $2.0 billion respectively.

## C. Deposits and Investments - Discretely Presented Component Units

### Deposits

At year-end, the carrying amount of discretely presented component units deposits, excluding those classified as investments, was $224.9 million. The deposits were reflected in the accounts of the banks at $258.0 million. Of the bank balances, $14.8 million was covered by federal depository insurance or by collateral held by the component units' agents in the component units' names (GASB credit risk category #1), $8.9 million was covered by collateral held in the pledging banks' trust departments in the component units' names (GASB credit risk category #2), $182.1 million was uninsured and uncollateralized (GASB credit risk category #3), and $52.2 million was held in money market funds which are not categorized.

### Investments

The investment authority for most discretely presented component units is typically found in their enabling statutes and/or their bond resolutions where applicable. Those component units which are financing authorities generally may invest in government or government backed securities and deposits. The Michigan Education Trust's investments are subject to an investment agreement with the State Treasurer which allows the Treasurer, acting as agent, to make diverse investments including stocks, bonds, notes, and other investments. Investment policies for the State universities are typically set forth by their governing boards and include a broad range of investment types.

### Restricted Assets

Restricted assets on the government-wide Statement of Net Assets, totaling $1.2 billion, represent amounts that are pledged toward the payment of outstanding bonds and notes.

The following table shows the carrying amounts and fair values of investments of the discretely presented component units, including deposits classified as investments on the balance sheet, by investment type and in total (in millions):

| | GASB Category | | | | | |
|---|---|---|---|---|---|---|
| | #1 | #2 | #3 | Not Categorized | Total Carrying Value | Fair Value |
| Deposits(1): | | | | | | |
| Time deposits | $ 8.9 | $ - | $ 5.9 | $ 5.3 | $ 20.1 | $ 20.1 |
| Government money market accounts | - | - | 10.3 | 33.3 | 43.6 | 43.6 |
| Investments: | | | | | | |
| Commercial paper | 165.9 | 11.0 | 12.2 | - | 189.2 | 189.2 |
| Short-term notes | - | - | 52.4 | 12.8 | 65.2 | 65.2 |
| Repurchase agreements | 3.5 | - | 8.9 | - | 12.3 | 12.3 |
| Government securities | 758.4 | 43.3 | 58.0 | - | 859.7 | 859.7 |
| Insured mortgage backed securities | 124.3 | - | 13.7 | - | 138.0 | 138.0 |
| Government backed securities | 2.2 | - | 164.2 | - | 166.4 | 166.4 |
| Investment agreements | - | - | - | 317.7 | 317.7 | 317.7 |
| Corporate bonds and notes | 278.6 | - | 62.8 | - | 341.4 | 341.4 |
| Preferred stock | - | - | - | .9 | .9 | .9 |
| Equities | 8.4 | .2 | 25.9 | 16.8 | 51.3 | 51.3 |
| Real estate | .2 | .1 | - | .6 | .9 | .9 |
| Venture capital and leveraged buyouts | - | - | - | 12.7 | 12.7 | 12.7 |
| Government money market funds | - | - | - | 61.9 | 61.9 | 61.9 |
| Mutual funds | - | - | 12.5 | 160.2 | 172.6 | 172.6 |
| Guaranteed investment contracts | 50.2 | - | 9.8 | 1,092.6 | 1,152.6 | 1,152.6 |
| Pooled investment funds | - | - | - | 461.2 | 461.2 | 461.2 |
| Other investments | - | - | 6.1 | - | 6.1 | 6.1 |
| Total Investments | $ 1,400.6 | $ 54.6 | $ 442.6 | $ 2,176.0 | 4,073.8 | $ 4,073.8 |
| Less Investments Reported as "Cash" on the Statement of Net Assets | | | | | (633.5) | |
| Total Investments | | | | | $ 3,440.2 | |
| As Reported on the Statement of Net Assets | | | | | | |
| Current investments | | | | | $ 690.4 | |
| Noncurrent restricted investments | | | | | 665.5 | |
| Noncurrent investments | | | | | 2,084.4 | |
| Total Investments | | | | | $ 3,440.2 | |

(1) The deposits classified as investments were reflected in the accounts of the banks in amounts equal to their carrying value and are categorized using the deposit risk category definitions.

### Interest Rate Exchange Agreements

The Michigan Higher Education Student Loan Authority (MHESLA) has an outstanding interest rate exchange agreement with an outside party for a notional amount of $11.0 million. The agreement converts MHESLA's interest rate exposure on $11.0 million of its fixed rate bonds to a variable rate allowing improved matching yields on variable rate student loans. The agreement, which matures on September 1, 2002, exposes MHESLA to credit loss in the event of nonperformance by the other party.

On January 2, 2002, Michigan State Housing Development Authority entered into a forward interest rate swap with outside parties for a notional amount totaling $60.0 million to hedge variable rate bonds that will be sold in 2002.